No. (1)

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1997

REBECCA ISQUITH, by her Custodian, FRED T. ISQUITH, Individually and on behalf of all others similarly situated,

Petitioner,

vs.

CAREMARK INTERNATIONAL, INC., C.A. LANCE PICCOLO, JAMES G. CONNELLY, III, THOMAS W. HODSON AND BAXTER INTERNATIONAL, INC.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

I.

Whether recipients of stock pursuant to a fraudulently induced spinoff transaction have any remedy under the federal securities laws.

II.

Whether, as the Second Circuit has held, to effectuate the purposes of the federal securities laws a fraudulent "spinoff" of securities can be deemed a "sale" or whether, as the Seventh Circuit has now ruled, a spinoff sale can only occur when: (a) the plaintiff-recipient of shares has relied on the fraud in making the "purchase" of the spinoff securities; or (b) the spinoff works a fundamental change in the nature of the investment.

III.

Whether, if the Seventh Circuit is correct in ruling that reliance must always be shown in order to state a claim under Section 10(b) of the Securities Exchange Act of 1934, the reliance element is satisfied when the plaintiff forbears from a state court suit to enjoin the spinoff, as the Second Circuit has held, or whether such forbearance is insufficient, as the Seventh Circuit has now held.

IV.

Whether, in the context of a motion to dismiss under Rule 12(b)(6), Fed. R. Civ. P., the complainant's well-pleaded allegations that the spinoff worked a fundamental change in plaintiff's investment must be accepted as true, thus rendering the spinoff a sale, or whether, as the Seventh Circuit has held, those allegations may be rejected as a matter of law before discovery.

LIST OF PARTIES

Petitioner:

Rebecca Isquith
Fred T. Isquith, her father and custodian

Respondents:

Caremark International, Inc.
C.A. Lance Piccolo
James G. Connelly, III
Thomas W. Hodson
Baxter International, Inc.

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Petitioner, Rebecca Isquith, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 136 F.3d 531 (7th Cir. 1998). It is reprinted in the Appendix as Appendix A. The District Court's unpublished opinion and order of March 26, 1997 is reprinted as Appendix B.

STATEMENT OF JURISDICTION

The Court of Appeals entered its judgment on February 4, 1998. This Court has jurisdiction to review the judgment by writ of certiorari under 28 U.S.C. § 1254(l).

STATUTE, REGULATION AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> Manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> > (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

> prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5; 17 C.F.R. 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange —
>
> > (1) To employ any device, scheme, or artifice to defraud;
> >
> > (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
> >
> > (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,in connection with the purchase or sale of any security.

Federal Rule of Civil Procedure 12(b)(6):

> (b) Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, cross-claim or third party claim, shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the

pleader be made by motion: . . . (6) failure to state a claim upon which relief can be granted.

STATEMENT OF THE CASE

A. Facts and Claims Asserted

In the early 1990's, Baxter International, Inc. ("Baxter") was a publicly traded health care company headquartered in suburban Chicago. One of its most profitable operations was its Caremark International, Inc. ("Caremark") subsidiary, which provided home drug infusion therapy that was less expensive than comparable hospital treatments.

In its annual reports, Baxter touted synergies between Baxter and Caremark. For example, in its 1990 Annual Report, Baxter credited the Caremark synergy for much of its overall success, stating "It's this combination [of Baxter and Caremark] that sets the company apart from others in the field — and creates added potential for world leadership." Baxter's 1991 Annual Report described how Baxter, through Caremark, formed partnerships with other health care providers to create "a strategic alliance based on a shared commitment to excellence in health care." Baxter's 1991 Annual Report stated that as an integrated company, through its Alternative Site business, Baxter was able to "track and administer a health-care drug benefit program more efficiently than companies can do on their own." In analyzing Caremark's importance to Baxter, the 1991 Annual Report refers to Caremark's Alternative Site business as "Baxter's fastest-growing business segment."

At least by 1992, as a result of an investigation by the Office of the Inspector General of the United States Department of Health and Human Services, Baxter management learned that Caremark's growth and profitability were attributable to

Caremark's practice of covertly making illegal "referral" payments to doctors to induce them to steer patients to Caremark.

Confronted with the Department of Health and Human Services' investigation, Baxter management issued public denials. But in secret, it acknowledged the problem and decided to distance itself from the fraud at Caremark, even if it meant destroying the synergies that Caremark contributed. The problem was how to do so without also revealing the fraud. A sale would likely entail a searching "due diligence" review by potential buyers. A public offering also would not work, because a due diligence review would be required there, too. Moreover, onerous liabilities could attach if the problem were not disclosed in the Securities and Exchange Commission ("SEC") registration statement that would be needed in connection with an offering.

Baxter management's solution was to attempt a "spinoff" of Caremark to Baxter's thousands of existing public shareholders. In a spinoff, the parent company distributes the stock of a wholly-owned subsidiary to its existing shareholders, but without filing a registration statement. It was anticipated that a spinoff, if it could be effected, would effectively deflect government inquiries directed at Baxter, and ultimately transfer responsibility for the Caremark fraud from Baxter management to Caremark's management, and the to-be-created group of Caremark shareholders, all without making dangerous misstatements in a registration statement, and without exposing Caremark to a due diligence review.

The key to a spinoff is a "no action" letter from the SEC, stating that the SEC will take "no action" to challenge what would, without the "no action" letter, automatically be deemed a "sale" of unregistered securities. L. Loss & J. Seligman, *Fundamentals of Securities Regulation*, 857 (3d ed. 1995) ("issuance does involve a 'sale' or 'purchase' for purposes of

Rule 10b-5"). "No action" letters are obtained by applying to the SEC. They are only granted if: (1) the parent company submits to the SEC and distributes to all who will receive the spinoff shares an accurate "Information Statement" containing most of the information about the spun off company's business that would ordinarily be found in a registration statement; and (2) the parent represents to the SEC that the spinoff has a legitimate business purpose. The function of the Information Statement is to ensure that stock in the spun off former subsidiary does not trade on the public markets until a full and accurate description of the subsidiary's business has been made widely available to the markets. *See* Thompson, *Registration of Stock Spin-Offs Under the Securities Act of 1933*, 1980 Duke L.J. 965, 980 (1980); Soderquist, L., *Understanding the Securities Laws*, 120 (3d ed. 1993); 17 C.F.R. 240.14c (1995).

Following this procedure, Baxter management submitted a proposed Information Statement to the SEC. It also represented that the proposed spinoff had a legitimate purpose, stating, contrary to its earlier positions, that Caremark was not a synergistic part of its business, that Caremark was really a burden and that the spinoff was designed "to eliminate a developing strategic competitive conflict between hospital customers of Baxter's hospital business and the Alternative Site business" operated by Caremark.

Having duly received documents that appeared to comport with the no action procedure, the SEC issued a "no action" letter and the Caremark spinoff proceeded to consummation late in 1992. Caremark established a new and separate legal, managerial and capital structure. Each Baxter shareholder received one share of Caremark stock for each four Baxter shares owned. In conformity with the spinoff's avowed purpose of enabling Caremark to chart its own course, free of constraints that existed when it was part of Baxter, Caremark did effect

rapid changes. It sold its home infusion business, along with its oncology infusion, physical therapy, orthopedic and nephrology business, and started a physician practice management business, all to "recast itself as a major player in . . . PBM [Pharmaceutical Benefits Management] and PPM [Physician Practice Management]."

In 1993, however, the fraud which had been the real motivating force behind the spinoff was revealed. Caremark pleaded guilty to two federal felonies involving violation of the Medicaid Referral Payment Law, 26 U.S.C. § 162, paid a record fine of $160 million to the federal government, and its stock plummeted. The net result of the spinoff was that Baxter management — no member of which was indicted or fined — had, via fraudulent means and at a transaction cost of tens of millions of dollars, safely distanced itself from the Caremark fraud, leaving Caremark shareholders to pay the price.

B. Course of Proceedings and Disposition Below

In 1994, petitioner Isquith, who, as a Baxter shareholder, received shares of Caremark in the spinoff, filed suit. She alleged that: (1) the distribution to her of shares in Caremark was a "sale" of such securities (or a forced "purchase" by her); (2) the defendants had made material misstatements and omissions in connection therewith, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5; and (3) that she had suffered damage as a result.

Defendants filed motions to dismiss under Rule 12(b)(6), Fed. R. Civ. P., arguing that the spinoff was not a sale for purposes of the federal securities laws. The district court agreed, and granted the motion. On appeal, the United States Court of Appeals for the Seventh Circuit affirmed the dismissal, rejecting

precedent which, if followed, would have dictated a contrary result.[1]

REASONS FOR GRANTING THE WRIT

The Seventh Circuit's decision warrants review because it:

- creates two conflicts in the circuits on the law applicable to spinoffs;
- works a fundamental and unwarranted narrowing of the scope of Section 10(b) of the Exchange Act;
- contravenes this Court's holdings in *Conley v. Gibson*, 355 U.S. 41 (1957), and related cases that the well-pleaded allegations of the complaint must be accepted as true on a motion to dismiss under Rule 12(b)(6), Fed. R. Civ. P.

I.

THE CIRCUITS ARE IN CONFLICT AS TO WHETHER A SPINOFF CAN BE A SALE.

The circuits are now split on whether the distribution of stock to shareholders in a spinoff can constitute a sale. In *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir. 1974), *cert. denied*, 417 U.S. 932 (1974) and *SEC v. Datronics*, 490 F.2d 250 (2d Cir. 1973), *cert. den.*, 416 U.S. 937 (1974), the courts held that a spinoff was a sale. They reasoned that while such a transaction might not bear all of the attributes of a

1. In the District Court and on appeal, defendants also argued plaintiff had sustained no damage. Neither the District Court nor the Court of Appeals accepted this argument and so it is not part of this petition.

sale of goods at common law, the securities laws were designed to promote full disclosure to the securities markets. *Securities Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953). Such purpose is frustrated, reasoned the courts, if securities in a new spinoff company can be introduced into the stream of commerce pursuant to fraudulent statements. *See also* T. Patton & T. Saunders, *Securities Fraud — Litigating Under Rule 10b-5*, § 2.4 (1992) ("better reasoned position seems to be that a spinoff may involve a change in ownership interest that is tantamount to a sale").

The rationale of these cases was elucidated in *SEC v. Harwyn Industries Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971), where the court stated in ruling that a spinoff was a sale for purposes of the Securities Act of 1933, 15 U.S.C. § 77, *et seq.*:

> Thus, regardless of the precise language of the federal securities laws, it is readily apparent that the Harwyn spin-offs violated the spirit and purpose of the registration requirements of § 5 of the 1933 Act, which is "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions" [citations omitted]. Furthermore, the registration provisions are designed not only to protect immediate recipients of distributed securities (in this case, Harwyn's outside stockholders) but also subsequent purchasers from them. [citations omitted].

The Seventh Circuit's opinion, holding that a spinoff cannot be a sale and rejecting a purposive application of the securities laws, conflicts with the contrary holdings in *Vesco*, *Datronics* and *Harwyn*. *See also* L. Loss & J. Seligman, *Fundamentals of Securities Regulation*, 856-862 (3d ed. 1995) (discussing wide ranging definition of "sale"); II L. Loss & J. Seligman, *Securities Regulation*, 1093 (3d ed. 1989).

The Seventh Circuit offered various rationales for not following *Vesco, Datronics* and *Harwyn.* Each, however, represents either a significant departure from precedent in other circuits, a fundamental misapplication of the securities laws, or a disregard for the principles behind Rule 12(b)(6), Fed. R. Civ. P.

II.

THE SEVENTH CIRCUIT MISAPPLIES SECTION 10(b) OF THE EXCHANGE ACT.

The Seventh Circuit ruled that plaintiff could not state a Section 10(b) claim because she had not "relied" on the Information Statement and had not made an "investment decision" in acquiring her Caremark shares. 136 F.2d at 535-36. The Seventh Circuit held that "reliance" is the *sine qua non* of an action under Section 10(b) and of a "sale." (*Id.*)

The Seventh Circuit misapplied Section 10(b). There are many behaviors that contravene Section 10(b) and constitute a "sale" which do not meet the reliance limitations imposed by the Seventh Circuit. Just last term, this Court held in *United States v. O'Hagan*, __ U.S. __, 136 L. Ed. 2d 695 (1997), that a lawyer who bought stock based on material, non-public information about an impending corporate takeover could be prosecuted for insider trading. While that case did not directly involve civil liability to the persons who sold the stock to O'Hagan, it has long been settled that such behavior violates Section 10(b) and SEC Rule 10b-5 and subjects people like O'Hagan to civil liability to those who sell contemporaneously with the inside trader's purchases, with no requirement that such persons rely on any statement. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

Similarly, it has long been the law that a stockbroker who "churns" his client's account, (*i.e.*, excessively trades the account to generate commissions) is guilty of a Rule 10b-5 violation. L. Loss & J. Seligman, *Fundamentals of Securities Regulation*, 908 (3d ed. 1995). This is so even where there has been no "representation" by the broker for the customer to have "relied" on, and where the customer is not aware that churning is occurring. (*Id.*)

Reliance is merely one way to demonstrate causation. There are others, most notably materiality. For example, in a spinoff, the shareholders usually have no choice in the way of voting, but if told all material facts have the option of court action to protect themselves. Conversely, the Seventh Circuit has now limited proof of causation solely to reliance — a construction uncalled for and contrary to law. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 383 (1920); *Caremark*, 136 F.3d at 534-535 (A. 7-8).

The "reliance" requirement that now applies to all Section 10(b) actions in the Seventh Circuit conflicts with the holdings of federal courts throughout the nation which have for years sustained recoveries, notwithstanding that the reliance requirement imposed by the Seventh Circuit is not met. The reason is that Section 10(b), far from being a simple federal codification of common law fraud, is a broad, remedial statute designed to guard the nation's securities markets from misinformation. VII L. Loss & J. Seligman, *Securities Regulation*, 3404 (3d ed. 1991). The Seventh Circuit's holding undermines that goal. It opens the floodgates to fraudulent spinoffs. It leaves the nation's securities markets vulnerable to the introduction of fraudulent securities, and the unsuspecting recipients of such stock without a remedy.

III.

THE SEVENTH CIRCUIT'S RULING CONFLICTS WITH THE SECOND CIRCUIT'S HOLDING IN *GOLDBERG v. MERIDOR.*

Even if the Seventh Circuit correctly interpreted Section 10(b) to require reliance in all instances, its holding conflicts with other circuits in terms of how the reliance requirement may be satisfied. In *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), and its progeny, courts held that when a shareholder is induced by fraud to refrain from seeking to enjoin or modify a proposed transaction, then that is sufficient reliance for purposes of Section 10(b). In the courts below, the plaintiff relied on this doctrine to show how she relied, if reliance were deemed necessary. The Seventh Circuit stated, in rejecting this argument, that *Goldberg* simply "is not good law in this circuit." 136 F.3d at 534. Had the Seventh Circuit followed *Goldberg*, plaintiff's case would not have been dismissed. The circuits thus conflict now on whether forbearance from suit constitutes reliance for purposes of Section 10(b).

IV.

THE SEVENTH CIRCUIT'S HOLDING VIOLATES *CONLEY v. GIBSON.*

The third rationale offered by the Seventh Circuit for dismissing the suit was that contrary to the plaintiff's allegations, the spinoff did not work a fundamental change in the plaintiff's investment. Relying on a line of cases originating in the Second Circuit beginning with *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 634 (2d Cir. 1967), and continuing through *7547 Corp. v. Parker & Parsley Development Partners*, 38 F.3d 211, 226 (5th Cir. 1994), plaintiff argued that the spinoff, which

according to Baxter's own request for a "no action" letter, was undertaken for the purpose of fundamentally altering both Baxter and Caremark, worked such a change in both companies that it was tantamount to a forced sale or purchase of Caremark stock.

The Seventh Circuit, referring to the fundamental change doctrine as "another esoteric and dubious judge-made doctrine," concluded that a spinoff could never be a fundamental change because at the moment of the spinoff the shareholder owns the same assets as before, only divided differently. 136 F.3d 535. Such a simplistic analysis, however, is not only contrary to the spirit of *Beneficial* and its progeny, but overlooks the nature of the spinoff at issue. Under the Seventh Circuit's analysis, a headless man is the "same" as a man with his head attached. They are the same molecules, only divided differently. Similarly, Baxter and Caremark were, as evidenced by Caremark's tumultuous post-spinoff history, much different as a duo than they were when Baxter owned Caremark.

The district court acknowledged the merits of plaintiff's contention. It noted that Baxter would not have effected a costly spinoff without some larger goal in mind, and that the investment risks of owning two non-synergistic companies — Baxter and Caremark — were far different than those of owning just one. The Seventh Circuit's disregard of the district court's findings, and its refusal to credit the obvious fundamental change that plaintiff pleaded, is a direct violation of Rule 12(b)(6) and *Conley v. Gibson*, 355 U.S. 41 (1957), which states that on a motion to dismiss, the allegations of the complaint and all inferences which follow must be accepted as true.

CONCLUSION

The Seventh Circuit's opinion cuts a swath through years of settled precedent. It undermines the purposes of the federal securities laws, disregards Supreme Court precedent, and conflicts with holdings of other circuits in two important ways. This Court should exercise its power to resolve these conflicts, and remedy the Seventh Circuit's errors.

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DECIDED FEBRUARY 10, 1998

Rebecca ISQUITH, by her custodian, Fred T. ISQUITH, individually and on behalf of all others similarly situated, Plaintiff-Appellant.

v.

CAREMARK INTERNATIONAL, INC., et al., Defendants-Appellees.

No. 97-2026.

United States Court of Appeals,
Seventh Circuit.

Argued Dec. 4, 1997.

Decided Feb. 10, 1998.

* * *

Before POSNER, Chief Judge, and CUMMINGS and MANION, Circuit Judges.

POSNER, Chief Judge.

This is a class action suit under Rule 10b-5 of the SEC and other antifraud provisions of federal securities law, with supplemental claims under state corporation law. The suit, against Baxter International (the pharmaceutical manufacturer) and a spun-off former wholly owned subsidiary of Baxter called Caremark, charges that Baxter submitted a fraudulent statement

to the Securities and Exchange Commission in connection with the spinoff. The district judge granted a motion to dismiss, holding that there was no purchase or sale of securities; relinquished jurisdiction over the supplemental claims, pursuant to 28 U.S.C. § 1367(c)(3); and so dismissed the entire case.

The complaint alleges that in 1991, when Caremark was still part of Baxter, the government began investigating Caremark for suspected Medicare and Medicaid fraud. While publicly denying any wrongdoing, Baxter feared the worst. Why is unclear, since a parent ordinarily is not liable for its subsidiary's torts; and if it is, a spinoff will not insulate it. We need not unravel these mysteries; all that is important is that, according to the complaint (the only source of factual allegations in the case), Baxter decided to try to insulate itself from any potential liability by spinning off Caremark, that is, by transferring the ownership of the subsidiary from Baxter to Baxter's shareholders, each to receive shares of Caremark proportional to their shares in Baxter, with the result that Caremark would no longer be a subsidiary of Baxter but an independent company. In order to be assured of not having to register the new security created to effectuate the spinoff — for the shares of Caremark, as of Baxter, were to be publicly traded — Baxter wanted a "no action" letter from the SEC. The Commission issued the letter upon Baxter's agreeing to file an "information statement," see 17 C.F.R. § 240.14c-2, that would among other things disclose the purpose of the spinoff. The statement said that the purpose of the spinoff was to avoid a looming competitive conflict between Caremark and other lines of Baxter's business. That, according to the complaint, was a lie; the purpose of the spinoff was to minimize the liability of Baxter's shareholders for Caremark's fraud. But the SEC issued the requested "no action" letter; the spinoff — which did not

require the consent of the shareholders — went through; and Baxter shareholders found themselves holding Baxter plus Caremark shares (one of the latter for every four of the former) rather than just Baxter shares.

The immediate effect of the transaction was to reduce the market value of Baxter stock because the spinoff had diminished Baxter's assets. But the market value of Baxter *and* Caremark stock — the only thing investors would care about — exceeded the value of Baxter stock before the spinoff. Eventually, however, the investing public got wind of Caremark's troubles, and the market value of its shares headed south. In 1995 Caremark pleaded guilty to criminal charges of fraud based on conduct going back to 1986 and paid the government $160 million.

The plaintiff class consists of the owners of Baxter shares at the time of the spinoff. The claim is that the spinoff constituted a forced "sale" of Caremark shares to them and that the sale was effected by fraud because, had the true purpose of the spinoff been revealed, owners of Baxter shares could have gotten the courts to block it; Baxter would then have been kept intact and Baxter stock would, they claim, today be worth more than the current combined value of Baxter and Caremark stock. It is difficult to see why, since Baxter's Caremark subsidiary, as it would have remained, would still have had to pony up the $160 million to the government. But the plaintiff argues, and in the posture of the case we must, though skeptical, accept, that the spinoff destroyed valuable synergies between Baxter and its Caremark subsidiary. If, however, whether on this or some other basis, the plaintiff could have gotten the spinoff enjoined, this implies that she can still sue for damages — as she has done, in the supplemental state law claim now pending

in state court. So it is very difficult to see how Baxter's coyness about the purpose of the suit hurt her or the other members of the class. She says she may have a statute of limitations problem with her state law claim. But if that problem is due to Baxter's fraud in concealing Caremark's troubles, she can set up that fraud as a defense to the statute of limitations — the defense of fraudulent concealment. See, e.g., *Cada v. Baxter Healthcare Corp.*, 920 F.2d 446, 451 (7th Cir. 1990).

The plaintiff hints that the SEC, too, would have blocked, or at least delayed, the spinoff had it learned of Caremark's illegalities. Yet she points to nothing in the laws administered by the SEC that would have authorized the Commission to impede the transaction had Baxter confessed that its motivation was to lighten its liabilities. That is not an improper motivation, and anyway the Commission's concern is with the completeness and accuracy of information provided to investors rather than with what the information reveals about the soundness or even morality of the investment. *Santa Fe industries, Inc. v. Green*, 430 U.S. 462, 477-78, 97 S.Ct. 1292, 1302-04, 51 L.Ed.2d 480 (1977); 1 Louis Loss & Joel Seligman, *Securities Regulation* 391 (3d ed. 1989). So if Baxter had come clean, the SEC would still have had no grounds for refusing to issue a no-action letter. And, at worst, Baxter would then have registered the Caremark stock.

There is a lot more that is wrong with this suit. Suppose Baxter had been candid with the SEC — and hence the public, because both the information statement and the no-action letter were public documents, and the statement, at least, was mailed to the shareholders — about Caremark's liability. Then the market value of Baxter's shares would have fallen immediately, discounting any anticipated losses resulting from that liability,

and the plaintiff class would have taken its hit then-before they could do anything about it — rather than later. Although investors who bought stock in Baxter or Caremark after the spinoff and in reliance on the stated purpose might have been hurt by Baxter's lack of candor, they are not members of the class. They have their own suit. The class in the present suit is limited to owners of Baxter shares at the time of the spinoff. If we assume with the plaintiff that Baxter would have been liable for its subsidiary's fraud, the spinoff shifted that liability to Caremark. Without the spinoff, it would have remained with Baxter. Since the members of the class owned both companies, the spinoff merely shifted liability from one pocket of their trousers to another. As for the loss of synergy, that has nothing to do with fraud. It is not a loss resulting from a misrepresentation or a misleading omission; it is a compounding of the poor business judgment that resulted in Caremark's getting into trouble with the government. The federal securities laws are not a remedy for poor business judgment. *Searls v. Glasser,* 64 F.3d 1061, 1069 (7th Cir. 1995); *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir. 1990); *Acito v. IMCERA Group, Inc.,* 47 F.3d 47, 53 (2d Cir. 1995).

The biggest problem with the suit is not the difficulty we're having figuring out how the members of the class could have been hurt by the alleged fraud in concealing the true purpose of the spinoff; for it is too early in the litigation to decide that this puzzle cannot be solved. Rather, it is the absence of other elements of federal securities fraud, such as that there have been a sale (or purchase — but for every purchase there is a sale). *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975); *Davidson v. Belcor, Inc.,* 933 F.2d 603, 605-06 (7th Cir. 1991); *Cohen v. Stratosphere Corp.,* 115 F.3d 695, 700-12 (9th Cir. 1997). The members of

the class did not buy or sell shares in Baxter. They did not buy or sell shares in Caremark. They simply received one share of Caremark stock for every four shares they owned of Baxter. They no more "bought" Caremark stock than the recipient of a stock dividend — which the plaintiff concedes the distribution of the Caremark stock was — buys the stock that he receives as a dividend. See *Rathborne v. Rathborne*, 683 F.2d 914 (5th Cir. 1982); cf. *Gelles v. TDA Industries, Inc.*, 44 F.3d 102 (2d Cir. 1994).

Words are protean in the hands of lawyers, so it can be argued that the Baxter shareholders were forced *in effect* to "buy" Caremark shares, "paying" for them by the reduction in the value of their Baxter shares as a result of the diminution in Baxter's assets that was brought about by the spinoff. But to accept this argument we would have to have a reason for *wanting* to play with words in this way, and we cannot think of any that advances the purposes of the securities laws. Those laws create a remedy, so far as bears on this case, for someone who is induced by ("relied on," the courts usually say) a misrepresentation or a misleading omission to buy or sell a stock. *O'Brien v. Continental Illinois National Bank & Trust Co.*, 593 F.2d 54, 60 (7th Cir. 1979); *In re NationsMart Corp. Securities Litigation*, 130 F.3d 309, 321 (8th Cir. 1997); *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994). This presupposes that the someone had a choice, a choice distorted by the fraud. The members of the class in this case had no choice. They made no investment decision. They therefore cannot have been induced by the alleged fraud to buy or sell any securities even if the spinoff can somehow be thought of as effecting a sale of their shares in Baxter.

"The members of the class in this case had no choice . . ." No *investment* choice, that is. They could have sued to try to

stop the spinoff. *Goldberg v. Meridor*, 567 F.2d 209, 218-21 (2d Cir. 1977) (Friendly, J.), holds that this option is enough to establish the materiality of a misleading statement to investors. See also *Field v. Trump*, 850 F.2d 938, 946-48 (2d Cir. 1988). But we rejected the doctrine of the *Goldberg* case in *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931-32 (7th Cir. 1988), and *Harris Trust & Savings Bank v. Ellis*, 810 F.2d 700, 704 (7th Cir. 1987); it is not good law in this circuit. *Goldberg* would allow every complaint about the mismanagement of a corporation that issues securities subject to federal securities law to be shoehorned into federal court on the theory that management had defrauded the shareholders by concealing the mismanagement. This would carry the securities laws far outside their intended domain. And it would violate the principle that the only loss of which complaint is possible under the antifraud provisions of those laws is a loss that candor would have averted. *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648-49 (7th Cir. 1997); *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447-49 (11th Cir. 1997). Candor would not have averted the consequences of whatever mismanagement or misfortune resulted in Caremark's scrape with the federal government. Even a successful suit to block the spinoff would not have eliminated the liability to the government that is the ultimate cause of the harm for which the plaintiff seeks redress, and anyway so far as appears the plaintiff can *still* bring such a suit, albeit now for damages rather than for injunctive relief. Even if she cannot, and even if, had it not been for the alleged fraud, the plaintiff would have succeeded in getting the spinoff enjoined, the cases that we have just cited show that she cannot maintain this suit, because the fraud did not cause the loss of investment value of which she complains — the scrape over Medicare and Medicaid did that.

This is a bit overstated; that scrape was the major cause of the loss in value, but there are also those synergies allegedly lost because the spinoff was not enjoined. If we assume that a damages suit is somehow blocked, or that the value of those lost synergies could somehow not be quantified (in which even the damages remedy would be inadequate) — and if we ignore the fact that if this is so, the plaintiff cannot obtain damages, the only relief sought, in the present suit either-then it would be the case that the fraud in the information statement filed with the SEC had caused a loss to the plaintiff. But as the cases we have cited (*Bastian* and the others) make clear, it would not be a loss on which a suit under the antifraud provisions of the securities laws can be based. For it would not be a loss of the *kind* that these laws are concerned with, namely a loss of investment value as a consequence of the concealment or distortion of the truth. In the lingo of securities law, the plaintiff would have shown "transaction causation" (the transaction, here the spinoff and resulting change in the form of the plaintiff's holdings, would not have occurred but for the fraud) but not "loss causation" (a loss produced by a discrepancy between the actual market value of a stock and what that value would have been had there been no misrepresentation). Had Baxter claimed that the spinoff would not sacrifice any synergies between Caremark and Baxter's remaining units, and the claim was a deliberate falsehood, the resulting drop in the value of Baxter's or Caremark's stock when the truth emerged would be a proper basis for suit. No such false claim is alleged. Not a lie about synergies, but a corporate reorganization, caused the loss of investment value consequent upon their destruction.

The plaintiff directs us to another esoteric and dubious judge-made doctrine, called the "fundamental change" doctrine. 8 Loss & Seligman, *supra*, at 3707-11. It began life as the

"forced seller" doctrine of *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 634-35 (2d Cir. 1967). Vine, a minority shareholder squeezed out by the majority, was allowed to characterize the transaction as a sale. Which in a sense it was, as he was forced to exchange stock for cash; that is what a squeeze-out does. But precisely because it was a *forced* sale, the plaintiff had not been induced to make it by a misrepresentation or misleading omission. There was no inducing; there was compulsion. And exactly the same thing is true here. The members of the class were not given a choice about whether to receive Caremark shares.

The doctrine of the *Vine* decision was limited in *Rathborne v. Rathborne, supra*. That case involved a spinoff, just like the present one, and the court held that the spinoff was not a sale of securities, since it did not effect a "fundamental change" in the plaintiff's holding. To the same effect, see *Gelles v. TDA Industries, Inc., supra*, 44 F.3d at 104-05. When *Vine* is read in light of these and other cases, such as *Sargent v. Genesco, Inc.*, 492 F.2d 750, 764-65 (5th Cir. 1974), and also in light of the Supreme Court's decision in *Blue Chip Stamps*, which made clear that the relevant provisions of the securities laws are limited to purchases and sales, the "forced seller" doctrine is seen to be limited to situations in which the nature of the investor's holding is so far altered as to allow the alteration to be characterized as a sale, as in the exchange of stock for cash in *Vine* itself. A change in form will not count as a sale and so will not be actionable; the change must be in some sense "fundamental" rather than nominal; hence the renaming of the doctrine. See 8 Loss & Seligman, *supra*, at 3710-11. The distinction is critical in this case. In a squeeze-out, stock is exchanged for cash; the person squeezed out no longer has any interest in the corporation; that is unquestionably a change in his bundle of property rights. In

a spinoff there is no exchange, no forced exit from the corporation, but merely the receipt by the corporation's shareholders of additional stock. Only the form in which the members of the class owned Baxter's assets was changed; it was changed from stock in one corporation to stock in two corporations. After the change the class members owned the same proportion, carrying the same rights, of the same pool of assets. Before, their ownership interest was denominated in shares of Baxter; after, in shares of Baxter and Caremark; the interest itself — the amount of assets owned by the members of the class — was unchanged.

So the fundamental-change doctrine, successor to the defunct forced-seller doctrine, is inapplicable to this case. And anyway we very much doubt that the doctrine retains any validity in any class of case, even in squeeze-out cases. In *Santa Fe Industries, Inc. v. Green, supra*, 430 U.S. at 473-77, 97 S.Ct. at 1300-03, decided after *Vine*, the Supreme Court made clear for the first time that securities fraud does not include the oppression of minority shareholders, which is what the plaintiff in *Vine* was complaining about. No more does securities fraud include unsound or oppressive corporate reorganizations, which is the essential complaint of the plaintiff class in this case. The fraud in concealing the purpose of the spinoff is merely the lever by which the class hopes to force into federal court a lawsuit over the wisdom of the spinoff. No doubt there should be legal remedies against fundamental changes in a corporation's structure that are undertaken in bad faith and hurt the shareholders; in fact there are; but a suit for securities fraud is not one of them. The office of securities fraud is to protect investors from being induced to make unsound sales or purchases by misrepresentations or misleading omissions. –

This is implicit in the requirement that the plaintiff, to maintain his suit, have relied on the fraud, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 243, 108 S.Ct. 978, 989-90, 99 L.Ed.2d 194 (1988), meaning that he changed his position because of it. It is implicit in the decisions that hold that there can be no suit under the securities laws by someone who has not made an investment decision, that is, who has not made a choice, a voluntary decision albeit one induced by the fraud, to buy or sell securities. *Davidson v. Belcor, Inc., supra*, 933 F.2d at 608; *Norris v. Wirtz*, 719 F.2d 256, 259-60 (7th Cir. 1983); *O'Brien v. Continental Illinois National Bank & Trust Co., supra*, 593 F.2d at 59-60. There was no investment decision in *Vine*. Our plaintiff relies on *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973), but that case is inapposite because while the SEC indeed obtained an injunction against spinoffs, their only purpose had been to evade the registration requirements of the securities laws. There is no claim here that the failure to register the Caremark shares violated any such requirement.

It is true that *Vine*, like this case, had a fraud "handle," and that might seem to take it out from under the rule of the *Santa Fe* case. The plaintiff claimed that the defendant had by means of fraud obtained the shares of enough other shareholders to be in a position to squeeze him out, to his injury. But that injury strikes us as too remote from the fraud to be actionable in a suit under the securities laws. It is one thing to say, as the Supreme Court did in *Basic Inc. v. Levinson, supra*, in adopting the "fraud on the market" theory of liability under the securities laws, that a misrepresentation directed at a group of investors may become impounded in the price of the stock (when members of the group buy or sell under the inducement of the misrepresentation) and so may induce a purchase or sale by

other investors. The misrepresentation induces action by those other investors, albeit indirectly. The misrepresentations in *Vine* were not directed at Vine and did not induce *him* to do anything; it made him vulnerable to a completely different kind of fraud — the abuse of minority shareholders by means of squeeze-outs, a form of fraud that the federal securities laws do not reach. And similarly in this case, the fraud by which Baxter allegedly obtained swift approval of the spinoff did not induce the members of the plaintiff class to buy or sell Baxter shares. It just made them vulnerable to what was neither a misrepresentation nor a purchase or sale of securities, but merely an involuntary change in the form of their holdings. Our *O'Brien* case featured the same fraud handle, see *O'Brien v. Continental Illinois National Bank & Trust Co., supra*, 593 F.2d at 60, yet we held that there was no purchase or sale of securities. We adhere to that decision, and note its inconsistency with the fundamental-change doctrine. But even if, as we greatly doubt, the doctrine is good law, it is, as we have explained, inapplicable to this case. To recapitulate: there was no forced sale, because only the form of the plaintiff's investment was changed; and anyway there was no reliance, no investment decision, because the plaintiff did not have a choice whether or not to accept the new stock.

AFFIRMED.

APPENDIX B — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED MARCH 26, 1997

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

No. 94 C 5534

Judge John A. Nordberg

REBECCA ISQUITH, by her custodian, Fred T. Isquith, individually and on behalf of all others situated,

Plaintiff,

v.

CAREMARK INTERNATIONAL, INC.; C.A. LANCE PICCOLO; JAMES G. CONNELLY, III; THOMAS W. HODSON; and BAXTER INTERNATIONAL, INC.;

Defendants.

MEMORANDUM OPINION AND ORDER

Plaintiff Rebecca Isquith, individually and on behalf of all others similarly situated, brings this action against Defendants seeking relief under federal securities law and state law. Plaintiff alleges Defendants made false and misleading disclosures relating to the finances and future business prospects of Caremark, Inc., an operating unit of Caremark International, Inc. These alleged disclosures were made pursuant to a "spinoff"

of Caremark[1] by its parent, Baxter International, Inc. ("Baxter"). Jurisdiction for the federal securities claims is founded on 15 U.S.C. § 77(v) and 28 U.S.C. § 1337; jurisdiction for the state claims is founded on 28 U.S.C. § 1367. Before the Court is Defendants' Motion to Dismiss.

I. Factual Background

Plaintiff alleges the following facts, which for the purposes of this Motion the Court assumes are true.

Until November 30, 1992, Caremark was a wholly-owned subsidiary of Baxter. A diversified health-care company, Caremark provides "alternate site patient care services" including infusion, growth hormone, hemophilia, physical, and rehabilitation therapies. In addition, Caremark distributes certain drugs, administers a prescription drug benefit program and a preferred provider network, and provides administration services for physician groups. During the class period, Defendant C.A. Lance Piccolo ("Piccolo") was Chairman of the Board and Chief Executive Officer of Caremark and executive vice president of Baxter; Defendant James G. Connelly, III ("Connelly") was President and Chief Operating Officer of Caremark and group vice president of Baxter; and Defendant Thomas W. Hodson ("Hodson") was a senior vice president and Chief Financial Officer of Caremark and group vice president of Baxter.

On November 30, 1992, however, Baxter "spun off" Caremark, distributing to its shareholders all the outstanding

1. For the purposes of this motion, the distinction between Caremark Inc. and Caremark International, Inc. is immaterial. Accordingly, the Court will disregard the separate identities of the two corporations and will use the term "Caremark" to refer to either entity.

shares of Caremark pro rata as a stock dividend, one share of Caremark common stock for every four shares of Baxter common stock. After the transaction, Caremark was a publicly-held company, its shares listed on the New York Stock Exchange.

Plaintiff, as well as each member of the proposed class, was a Baxter shareholder at the time of the Caremark spin-off. Hence, Plaintiff received shares of Caremark in the above-described distribution.

Plaintiff alleges the spin-off of Caremark as a completely separate company fundamentally altered the nature of Plaintiff's investment. In support of this conclusory allegation, Plaintiff points to Baxter's pre-spinoff statements in its 1990 and 1991 Annual Reports touting synergies gained by retaining Caremark as part of Baxter, synergies which would be lost were Caremark to be spun off. Additionally, Plaintiff alleges the Information Statement filed with the SEC and prepared in connection with the Caremark spinoff cited various business reasons, including enhanced growth prospects, supporting the spinoff of Caremark, each of which would represent a change in Plaintiff's investment.

As Defendants do not dispute that Plaintiff sufficiently alleges Defendants omitted and misrepresented material facts concerning Caremark, the Court need not delve deeply into the Defendant's alleged omissions and misrepresentations. In brief, Plaintiff alleges Caremark, both as a subsidiary of Baxter and following the spinoff, engaged in an illegal kickback scheme, paying doctors for referrals to its infusion unit. Not surprisingly, Defendants did not disclose this alleged practice in Baxter SEC filings, communications with shareholders, or the Information

Statement. In June 1995, Caremark pled guilty to federal criminal charges relating to the alleged kickback scheme and to various other federal and state violations, and paid $160 million to resolve an investigation conducted by the Office of Inspector General for the United States Department of Health and Human Services. Plaintiff further alleges that one of the unstated reasons for the spinoff was concealment of the kickback scheme and the directors' and officers' failure to disclose its existence.

II. Standard for Motion to Dismiss

The purpose of a Rule 12(b)(6) motion is to test the legal sufficiency of a complaint. *See Adams v. Cavanaugh Communities Corp.*, 847 F. Supp. 1390, 1396 (N.D. Ill. 1994). In order to survive a motion to dismiss, a complaint must allege sufficient facts to outline a cause of action. *Davis v. Frapolly,* 747 F. Supp. 451 (N.D. Ill. 1989). The complaint "must state either direct or inferential allegations concerning all of the material elements necessary for recovery under the relevant legal theory." *Carl Sandburg Village Condominium Ass'n No. 1 v. First Condominium Dev. Co.*, 758 F.2d 203, 207 (7th Cir. 1985).

The Court must accept as true all well pleaded factual allegations in the complaint and view them, along with the reasonable inferences to be drawn from them, in the light most favorable to the plaintiff. *Cornfield v. Consolidated High School District No. 230,* 991 F.2d 1316, 1324 (7th Cir. 1993). However, the Court need not accept as true conclusory legal allegations. *Baxter v. Vigo County School Corp.*, 26 F.3d 728, 730 (7th Cir. 1994). When evaluating the legal sufficiency of a plaintiff's factual allegations, courts are held to a strict standard. A motion to dismiss may be granted only if "it appears beyond

doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Cushing v. City of Chicago*, 3 F.3d 1156, 1159 (7th Cir. 1994).

III. Analysis

A. Federal Securities Law Claims

Plaintiff claims she states causes of action pursuant to § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("1934 Act") (Count II) and §§ 12(2) and 11 of the Securities Act of 1933 ("1933 Act") (Counts I and III, respectively). In order to state a claim under each of these causes of action, Plaintiff must allege she is a "purchaser or seller" of securities (hereinafter, the "purchaser-seller requirement"). *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735-36 (1975). This requirement, usually dubbed a standing requirement, "maintain[s] the balances built into the congressional scheme by permitting damage actions to be brought only by those persons whose active participation in the marketing transaction promises enforcement of the statute without undue risk of abuse of the litigation process and without distorting the securities market." *Id.* at 739 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 492 F.2d 136, 147 (9th Cir. 1974)). *See also, Fry v. UAL Corp.*, 84 F.3d 936, 938 (7th Cir. 1996) (explaining the danger of overdeterring of securities fraud).

Plaintiff claims that her receipt of Caremark stock distributed pursuant Caremark's spinoff by Baxter satisfies this standing. Defendants, however, contend that the spinoff of Caremark and the resulting distribution of Caremark stock to Baxter shareholders was not a sale within the meaning of the

purchase-seller requirement; therefore, Defendant argues, Plaintiff does not satisfy the purchaser-seller requirement and, consequently, does not state a claim under the federal securities laws.

At first blush, Plaintiff's position appears unwarranted, her receipt of Caremark shares through the spinoff appearing nothing like a purchase or sale of securities. However, "sale" is defined broadly in both securities acts. The 1933 Act defines "sale" to include "every contract of sale or disposition of a security or interest in a security for value." 15 U.S.C. § 77(b)(3). Similarly, the 1934 Act defines "sale" to include "any contract to sell or otherwise dispose of" a security. 15 U.S.C. 78c(1)(13).[2] Accordingly, the courts have found "a statutory purchase or sale [in] transactions that bear little resemblance to conventional common law purchases and sales." *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982); *see also, In re American Continental Corporation/Lincoln Savings & Loan Securities Litigation*, 49 F.3d 541, 543 (9th Cir. 1995) (" 'purchase or sale' requirement should be read flexibly in order to effect

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2. Due to the "for value" clause in the 1933 Act definition of "sale", courts have found that "sale" is defined more broadly under the 1934 Act than under the 1933 Act. *Carter v. Signode Indus., Inc.*, 694 F. Supp. 493, 496 (N.D. Ill. 1988). Thus, a transaction deemed a "sale" for purposes of the 1933 Act is also a sale for purposes of the 1934 Act; however, a transaction deemed a "sale" for purposes of the 1934 Act might not be a sale for purposes of the 1933 Act. As the Court ultimately finds the Caremark spinoff is not a sale, it is sufficient for the Court to analyze the transaction under the 1934 Act definition: The Court's finding that the spinoff is not a sale under the 1934 Act implies that it is not a sale under the 1933 Act. Accordingly, the Court applies the 1934 Act definition of sale for the purposes of this motion.

securities laws' remedial purposes.") For instance, the Seventh Circuit has found that an "exchange of shares during a merger transaction constitute[s] a purchase or sale of securities for the purposes of Section 10(b) and Rule 10b-5." *Davidson v. Belcor, Inc.*, 933 F.2d 603, 606 (7th Cir. 1991). Also, pledges of stock as collateral for loans have been deemed sales. *Rubin v. United States*, 449 U.S. 424, 431 (1981) (examining the "economic considerations and realities" of the transaction). Accordingly, the fact that the Caremark spinoff does not look like a typical sale of securities does not establish that, for the purposes of the purchaser-seller requirement, the distribution of Caremark stock was not a sale: A closer look is required.

Although the Seventh Circuit has not specifically ruled as to whether, and under what conditions, a stock distribution conducted pursuant to a spinoff may be considered a purchase or sale for the purposes of the purchaser-seller requirement, the Seventh Circuit has instructed courts applying the requirement to focus on whether the transaction in question required the plaintiff to make an "investment decision." *Davidson v. Belcor, Inc.*, 933 F.2d 603, 606 (7th Cir. 1991); *Norris v. Wirtz*, 719 F.2d 256, 259-60 (7th Cir. 1983); *O'Brien v. Continental Illinois National Bank & Trust Co.*, 593 F.2d 54, 60 (7th Cir. 1979). Where a transaction does not require an investment decision, that transaction is not considered a "purchase or sale" for the purposes of the purchaser-seller requirement. Explaining the basis for this rule, the Seventh Circuit observed that "the fundamental purpose of Section 10(b) and Rule 10b-5 is to implement a policy of full and fair disclosure so that potential purchasers and sellers can make informed investment decisions." *Davidson v. Belcor, Inc.*, 933 F.2d at 606 (citing *Sante Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977)). Accordingly, the Seventh Circuit is "reluctant to imply a 10b-5 cause of action

for wrongs that do not fall with § 10(b)'s fundamental purpose of requiring full and fair disclosure to participants in securities transactions of the information that would be useful to them in deciding whether to buy or sell securities." *Davidson*, 933 F.2d at 606 (quoting *O'Brien*, 593 F.2d at 60.) Hence, where the investor has not made an investment decision, the transaction is not sale or purchase and the investor is not a purchaser or seller.

Under the investment decision doctrine, Plaintiff clearly is not a purchaser or seller of securities. In order to receive the distribution of Caremark shares, no shareholder action was required; instead, Baxter shareholders, including Plaintiff, were passive recipients of the shares, issued automatically in the form of a stock dividend to Baxter common shareholders. The transaction not requiring shareholder approval, the shareholders were powerless to prevent the distribution of Caremark. Accordingly, Plaintiff "was never in a position to make an investment decision regarding the securities and is, therefore, not a member of the class of plaintiffs which the federal securities laws are designed to protect." *O'Brien*, 933 F.2d at 608-09. Hence, Plaintiff does not satisfy the purchaser-seller requirement under the investment decision test.

Plaintiff, however, contends that the investment decision test is not determinative, arguing that the court should also apply the "fundamental change" doctrine (also called the "forced seller" doctrine) recognized in some other circuits. Under the fundamental change doctrine, "where a securities transaction results in a fundamental change in the nature of a shareholder's investment, leaving the plaintiff with shares that represent a participation in a wholly new and different enterprise, the plaintiff may be considered a purchaser or seller." *Rathborne*, 683 F.2d at 921. *See also, 7547 Corp. v. Parker & Parsley*

Devel. Partners, 38 F.3d 211, 226 (5th Cir. 1994) (plaintiff is a purchaser or seller when her "interest in a company is fundamentally altered through a merger, acquisition, or liquidation"); *Vine v. Beneficial Finance Co.,* 374 F.2d 627 (2d Cir. 1967); *Abrahmson v. Fleschner,* 568 F.2d 862, 868 (2d Cir. 1977) ("There must be such significant change in the nature of the investment or the investment risks as to amount to a new investment"). The fundamental change test applies whether or not plaintiff made an investment decision; if plaintiff's investment is fundamentally changed by a securities transaction, plaintiff may be considered a purchaser or seller despite not having made an investment decision. To determine whether a fundamental change has occurred in plaintiff's investment, courts look to the " 'economic reality' of the transaction and determine whether the transaction has 'transformed' the plaintiffs interests in any real sense.' " *Rathborne,* 683 F.2d at 920 (*citing United Housing Foundation v. Forman,* 421 U.S. 837, 848 (1975)). "[T]he core issue is whether the transaction has transformed the plaintiff into the functional equivalent of a purchaser or seller . . ." *Id.* at 920.

Contending the Caremark spinoff was a fundamental change in her investment, Plaintiff contends she should be considered a purchaser-seller under the fundamental change test. Plaintiff's original investment was an interest in a single corporation, Baxter, of which Caremark was a wholly-owned subsidiary. However, the spinoff transformed her investment into interests in two distinct companies, Baxter and Caremark with separate risks and prospects. In particular, the combined organization lost "synergies" of operating as a single entity, synergies heralded by Baxter in pre-spinoff Annual Reports. *See e.g.,* Complaint ¶ 24(b) ("The 1990 Annual Report concludes, '[the combination] sets the company apart from others in the field —

and creates added potential for world leadership in a vital industry.' ") Accordingly, Plaintiff maintains, the spinoff caused a fundamental change in her investment and she should be regarded as a purchaser or seller.

Expressly leaving the issue unresolved, the Seventh Circuit has not decided if the fundamental change doctrine is recognized in this circuit. *Ray v. Karris,* 780 F.2d 636, 640 n.1 (7th Cir. 1985). District courts in the Northern District of Illinois have utilized the fundamental change doctrine in determining whether a transaction is a purchase or sale. See *Carter v. Signode Industries, Inc.,* 694 F. Supp. 493, 497 (N.D. Ill. 1988) (Aspen, J.); *FMC Corp. v. Boesky,* 727 F. Supp. 1182, 1194 (N.D. Ill. 1989) (Williams, J.). But the Court need not determine whether to follow the lead of these courts; even if the fundamental change doctrine is recognized by the Seventh Circuit, the facts alleged by Plaintiff do not warrant application of the doctrine.

As Plaintiff contends, the spinoff of Caremark did change Plaintiff's investment to some degree. As companies undergoing spinoffs incur substantial costs in executing the involved transactions, spinoffs must have an effect on the prospects of the newly divided companies; otherwise the companies simply would forego the exercise and keep the money in the corporate coffers. Indeed, Baxter cited various benefits of the spinoff in the Information Statement, like enhanced growth prospects for Caremark. (Complaint ¶ 37.) Therefore, reading the allegations in the light most favorable to Plaintiff, the Court presumes that the spinoff had some impact on Plaintiff's investment by possibly altering the economic prospects of the newly-divided companies.[3] Additionally, Plaintiff's investment was altered by

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3. Plaintiff's listing of actions taken by Caremark after the spinoff is inapposite, however. (Pl. Brief Opp. at 20.) Each of the (Cont'd)

unbundling her ownership stakes in Baxter and Caremark. Prior to the spinoff, one could not own a stake in Caremark without owning a stake in Baxter, and vice versa; after the spinoff, one could. One could even go "long" on one and "short" on the other, thereby betting with one and against the other. Thus, while Plaintiff's proportionate stake in each enterprise was the same before and after the spinoff, the spinoff allowed her to vary her stake in each enterprise going forward. Consequently, the stock dividend of Caremark shares to Baxter shareholders was not akin to a simple stock split in which the nature of the shareholders' interest is wholly unaffected. See *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir. 1949) (stock dividend of own corporation's own stock is not a sale). The spinoff of Caremark did have consequences to Plaintiff's investment.

However, the Court finds these changes were not "fundamental." Analyzing a transaction identical in form to the Caremark spinoff, the Fifth Circuit, the leading circuit in developing the fundamental change doctrine, found that the transaction was not a fundamental change in the plaintiff's investment. *Rathborne*, 683 F.2d at 920 (affirming lower court's dismissal of action for failure to state a claim.[4] In particular, the *Rathborne* court found that the plaintiff "continued to possess the same proportionate interests in the same enterprises, with the same assets, and the same prospects." *Id.* While the *Rathborne*

(Cont'd)
named actions could have been undertaken whether or not Caremark was spun-off.

4. Plaintiff's attempt to distinguish Rathborne from this case is mystifying. Contrary to Plaintiff's claim, the Rathborne court did not find that the transaction at issue was not a "spinoff"; it merely distinguished that particular spinoff from spinoffs in other cases.

court may have overstated the identity of the pre-and post-transaction entities with respect to their economic prospects, the Court agrees with its conclusion. Although the Caremark spinoff entailed some change in Plaintiff's investment, the spinoff left Plaintiff with the same proportionate ownership of the same corporate assets. Hence, the economic reality is that Plaintiff's investment is little changed. See also, *FMC Corp. v. Boesky*, 727 F. Supp. at 1194. Whatever changes occurred in Plaintiff's investment simply are not sufficient to be found "fundamental" as that term is used in the fundamental change doctrine, to wit, the transaction did not "transform the plaintiff into the functional equivalent of a purchaser or seller." *Rathborne,* 683 F.2d at 920.

The cases cited by Plaintiff, supposedly establishing that a spinoff is a sale, do not compel a contrary conclusion. In *S.E.C. v. Harwyn Industries,* 326 F. Supp. 943, 953-54 (S.D.N.Y. 1971) and *S.E.C. v. Datronics Engineers, Inc.,* 490 F.2d 250 (2d Cir. 1973) courts found the spinoff transactions at issue were "sales". In each case, however, the SEC was bringing an enforcement action, so the courts were not considering the definition of "sale" in the context of an investor cause of action. As the *Rathborne* court implicitly finds, "sale" may be interpreted differently in the contexts of SEC enforcement actions and private damage actions, particularly with respect to the standing requirement. *Rathborne,* 683 F.2d at 920 n.21.

But more fundamentally, both the *Harwyn* and *Datronics* spinoffs are readily distinguishable from the Caremark spinoff. Both involved an allegedly-abusive practice called "going public through the back door." Under this practice which was popular enough to be featured in a March 29, 1969 Business Week article, a publicly-traded company would acquire another

company, not publicly-traded, and promptly thereafter spin off shares in that company without going through the registration process. *Harwyn*, 326 F. Supp. at 949. Most notably the spun-off company was acquired for the sole purpose of spinning it off. *Datronics,* 490 F.2d at 255. The object was to create an active market for the spun-off shares, typically in the thinly-traded, "pink-slip" over-the-counter market. *Id.* at 254; *Harwyn,* 326 F. Supp. at 949.

This genre of spinoffs differs fundamentally from the Caremark spinoff, and consequently *Harwyn* and *Datronics* are inapplicable to this action. Most tellingly, Caremark was neither recently acquired by Baxter not acquired with the sole purpose of spinning it off in an end-run around the 1933 Act registration process. Furthermore, the Caremark shares were not spun-off to be traded in (inefficient) thin markets. On the contrary, Caremark was immediately listed on the New York Stock Exchange, doubtlessly to be covered by major brokerage houses. Therefore, the Caremark spinoff does not bear the hallmarks of the abusive practices targeted by the *Harwyn* and *Datronics* courts. Accordingly, the Court finds that neither decision supports Plaintiff's proposition that the Caremark spinoff should be considered a purchase or sale.[5]

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5. The court notes that under the fundamental change doctrine, the spinoffs in *Harwyn* and *Datronics* likely would be considered purchases or sales. As the pattern involves an acquisition of a company before the same company is spun off. New assets are added to the original corporation for a time. Therefore, the investment has been fundamentally changed over the course of the entire pattern. *See Rathborne*, 683 F.2d at 918, 921. Consequently, the fundamental change test would allow standing for recipients of spun-off stock under the circumstances presented in *Harwyn* and *Datronics*. Hence the rulings in *Harwyn* and *Datronics* do not reach abusive practices not caught in the net of the fundamental change doctrine.

Finally, the Court rejects Plaintiff's suggestion that refusing standing to Plaintiff opens a gaping loophole in the registration process. First, if the Court's decision opened such a loophole, one would have expected an avalanche of spinoff abuses following the *Rathborne* decision. As the paucity of case deciding whether a spinoff may be regarded as a purchase or sale clearly indicates, such an avalanche has not occurred. Second, persons in Plaintiff's position, recipients of shares of spun-off companies, are adequately protected by state law remedies. At the core of Plaintiff's complaint are alleged breaches of fiduciary duties by Baxter and Caremark directors and officers. These duties are owed to Plaintiff and each member of the proposed class and state law provides broad remedies of their breach. Thus, Plaintiff's claim that this ruling would "leave victims of fraudulent spinoffs remediless, and open the floodgates to precisely the sort of fraudulent transaction which the law was designed to prevent" is not only contradictory to her contemporaneous pursuit of various state law claims, but it is also just plain false.

As the Court finds that the Caremark spinoff is not a sale, and therefore Plaintiff does not satisfy the purchaser-seller requirement, Plaintiff fails to state a claim under the federal securities laws. Consequently, the Court dismisses with prejudice Counts I , II, and III of Plaintiff's Second Amended Complaint.[6]

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6. As the Court found that Plaintiff does not state a claim based on the standing issue, the Court need not consider Defendant's remaining arguments for dismissal of Plaintiffs federal securities claims. The Court notes, however, that the additional grounds for dismissal argued by Defendants largely serve to justify a finding that the spinoff was not a sale for the purposes of a private damages action, rather than being truly independent grounds for dismissal. The difficulties of identifying causation, reliance and damages all flow from the fact that there was not an identifiable "sale".

Appendix B

B. State Law Claims

Having dismissed Plaintiffs federal securities claims, the only claims over which the Court has original jurisdiction, the Court declines to exercise supplemental jurisdiction over Plaintiff's state law claim. 28 U.S.C. § 1367(c)(3). The court is mindful of the Supreme Court's admonition that if the federal claims are dismissed before trial, then the state claim's should be dismissed as well. *United Mine Workers v. Gibbs,* 383 U.S. 715, 726 (1972).

IV. Conclusion

For the aforementioned reasons the Court GRANTS Defendant's Motion to Dismiss. Accordingly, Plaintiff's federal securities claims, Counts I, II, and III, are dismissed with prejudice and Plaintiff's state law claims are dismissed without prejudice.

ENTER:

s/ John A. Nordberg
John A. Nordberg
United States District Judge

DATED: March 26, 1997